MEETING THE CHALLENGE

To achieve the goals set out in the introduction to this report, it is necessary to understand the economic and fiscal challenge facing the country. That challenge is broad, deep, and multifaceted. The discussion below aims not only to examine its separate components, but also to show how they are interrelated, requiring a *comprehensive* strategy for addressing them.

HEALTH CARE

Spending on health care in the United States, counting both private and public expenditures, currently totals more than $2.1 trillion per year – roughly 15.9 percent of gross domestic product [GDP]. In part, this level of spending reflects the generally high standards of care available in the U.S., the extraordinary advances in medical technology, and the value Americans place on this most personal of services.

But whether Americans receive a commensurate value for this level of health spending is in doubt. Says Harvard Professor Regina E. Herzlinger: "Sure, we have some great doctors, hospitals, and medical technology; but quality varies wildly among and within providers of health care. And because of the lack of integration of medical care delivery for the chronic diseases and disabilities that account for 80 percent of health care costs, patients fall between the cracks – for example, kidney disease patients don't get the preventive care they desperately need to halt the progression of their deadly disease." (Herzlinger, *Who Killed Health Care?*, 2007)

Isabel V. Sawhill, a senior fellow at the Brookings Institution, puts it another way: "We spend about twice as much on health care in this country as in any other industrialized country and we do not get better outcomes." (Sawhill, *Does It Take a Commission? Health Care and the Federal Budget*, speech to the National Press Club, 5 May 2008)

Moreover, medical costs are rising at about 6.7 percent per year, significantly faster than the growth of real GDP and inflation. According to the Congressional Budget Office [CBO], under current trends, total spending on health care will rise to 25 percent of GDP by 2025, 37 percent in 2050, and 49 percent – nearly half of all U.S. economic resources – by 2082. (CBO, *The Long-Term Outlook for Health Care Spending*, November 2007) As a result, health care spending will increasingly crowd out other priorities, from education to infrastructure.

This rate of growth is pushing up health insurance premiums, making coverage more and more difficult for many Americans to afford. The average monthly worker premium contribution to an employer-sponsored family insurance plan has risen from $129 in 1999 to $273 in 2007, an increase of 112 percent. (The Kaiser Family Foundation and the Health Insurance and Educational Trust, *Employer Health Benefits – 2007 Annual Survey*, 2007) Small businesses frequently cannot afford group insurance for their employees, and large companies have tended to restrict the choices of employee coverage on the premise that such restrictions would restrain cost growth. At the same time, policies for self-employed persons are often prohibitively expensive. Worse, individuals suffering chronic medical conditions often are branded "uninsurable," because insurance for them would be too expensive.

Rising costs are the main reason why an estimated 47 million Americans have no health insurance coverage, from either the market or the government. The uninsured often fail to seek appropriate medical care, for themselves or their children, until their needs become critical – risking more serious, and more expensive, illnesses. In addition, they have no means of paying for catastrophic medical events, should they occur – and may face bankruptcy because of it. Alternatively, doctors and hospitals that provide care shift the costs to other patients and insurers.

Rising health care spending also is the major contributor to the unsustainable projected increases in the Federal Government's two major health programs, Medicare and Medicaid, which are the main contributors to projected chronic Federal budget deficits. The effect of this spending growth is even greater than that of lengthening life-spans and the forthcoming retirement of the baby boomers. "Long-term deficits are driven not only by the aging of the population," says Dr. Sawhill. "[T]hey are much more driven by increasing health care costs per capita . . . The demographics play a role. But if you look at the numbers carefully you will see that the problem has been health care spending per capita that has been growing 2 to 3 percent faster than per-capita incomes or per-capita GDP." (Sawhill, *Does It Take a Commission? Health Care and the Federal Budget*, speech to the National Press Club, 5 May 2008) During the period 1999 through 2008, the monthly premium for seniors who participate in Medicare has risen at nearly the same rate as those in private insurance, from $45.50 to $96.40. (*The 2007 Annual Report of the Board of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Fund*, March 2007)

Table 1: U.S. Health Care Spending, by Source of Funds, 2006

	Billions of Dollars	Percent of Total Spending
Private Spending		
Private Health Insurance	723.4	34.4
Out-of-Pocket Payments	256.5	12.2
Other Private Spending[a]	155.3	7.4
Subtotal: Private Health Spending	**1,135.2**	**53.9**
Public Spending		
Medicare	401.3	19.1
Medicaid[b]	308.6	14.7
Other Public Spending[c]	260.5	12.4
Subtotal: Public Health Spending	**970.4**	**46.1**
Total	**2,105.6**	**100.0**

[a] Includes philanthropy and spending by on-site clinics maintained by employers.
[b] Includes both Federal and State spending.
[c] Includes spending by State and local health departments, the Department of Veterans Affairs, the Department of Defense, workers' compensation programs, and the State Children's Health Insurance Program.
Source: Congressional Budget Office, and Centers for Medicare and Medicaid Services.

Furthermore, the government health programs rely on the infrastructure of private health care. As CBO notes: "[M]ost [public] services are furnished by private providers. For example, Medicare and Medicaid beneficiaries receive most of their care from physicians, hospitals, and other providers that deliver services to the general population." (CBO, *The Long-Term Outlook for Health Care Spending*, December 2007) Therefore, inadequacies or inefficiencies in private health care services affect Medicare and Medicaid as well. It is another reason why correcting problems in the government health entitlements requires addressing inefficiencies in the market.

But if rising private health costs drive the growth of Medicare and Medicaid spending, *the converse also is true*: Medicare and Medicaid themselves contribute in their own way to medical inflation. These two programs account for roughly 34 percent of all health care spending nationally (including the State share of Medicaid), according to the most recent figures from CBO (see Table 1). Another 12 percent comes from other public programs, including those of State and local health departments, the Department of Veterans Affairs, and workers' compensation. Such large infusions of government funds inevitably stoke rising medical costs. Furthermore, real per-capita growth in Medicare and Medicaid spending has outpaced that occurring in the market (see Table 2). This demonstrates that government spending tends to be less efficient than spending in the market. Hence, *overall medical costs cannot be tamed without also addressing the structure of the Federal health entitlements*.

Table 2: Real Per Capita Growth in Medicare, Medicaid, and All Other Health Care Spending
(percent growth)

	Medicare	Medicaid	All Other	Total
1975 to 1990	5.4	5.4	4.8	5.1
1990 to 2005	3.8	3.3	3.1	3.4
1975 to 2005	4.6	4.4	4.1	4.3

Source: Congressional Budget Office, *The Long-Term Outlook for Health Care Spending*, November 2007

Given that all these elements of health care are interrelated, the following sections examine the separate components more closely. The aim is to build a better understanding of what kinds of remedies might succeed, and what kinds will not.

The Private Health Care Market

Private health care in America is not a "system," as many casually describe it: it has no formalized organization, and no single designated authority to run it. Like most enterprises in the U.S. economy, private health care financing and delivery operates in a *market*, with numerous participants – including the government – who interact voluntarily, and readjust their activities in response to incentives and disincentives and other changes. This is not a flaw, but a necessary recognition: because of the market's naturally dynamic nature, attempts to further "systematize" health care will only make it either more costly or more restrictive. As Michael J. Novak Jr. explains: "In most economic markets, particularly those with millions of participants, no single human intelligence seems adequate to grasping the needs of individuals. Central planners have a record of building up wasteful surpluses in some areas, precipitating unplanned-for shortages in others. Queues and illicit black markets result. . . . Perhaps worse, incentives to individual intelligence are few and the common fund of invention shrinks." (Novak, *The Spirit of Democratic Capitalism*, 1982)

This insight explains much of what has gone wrong in health care over the past several decades. The problems have been caused not by a failure of the health care market, but mainly by distortions imposed on the market from several directions. For example, the potential for competition by physician-controlled specialty hospitals, which can provide better and less expensive services than larger institutions, often has been suppressed. Large employers have tended to restrict employees' choices of health insurance policies under an assumption that this would control costs. Some managed care organizations have drifted more toward reducing costs than focusing on providing better, more integrated, and less expensive health care – to the frustration of patients. Government bureaucrats have tended to prescribe, and thereby interfere in the ways doctors serve patients. All of this has occurred with the endorsement or assistance of government at the local, State, and Federal levels.

While medical prices have risen, the return to medical professionals has not; and this trend has limited the *supply* of medical providers, which also tends to keep prices higher than necessary. As Professor Herzlinger writes:

> [P]hysicians' inflation-adjusted incomes dropped by 7 percent from 1995 to 2003, while those of professional and technical workers increased by 7 percent. And, increasingly, physicians are asked to follow medical care recipes concocted by insurers and government bureaucrats. With their professional autonomy and financial well-being compromised, small wonder that the number of applicants to medical schools decreased by nearly 20 percent between 1996 and 2006. (Herzlinger, *Who Killed Health Care*, 2007)

Yet with all this, there is another, even more fundamental problem. It lies in the *Federal tax code* – specifically the tax exclusion for employer-provided health coverage. This policy undermines the health care market by hiding the true cost of insurance from those covered by it, and contributing to more expensive care and more costly insurance. As C. Eugene Steuerle of the Urban Institute describes it:

> The exclusion is open-ended. The more insurance we buy, the larger the amount of income we get to exclude from tax and the more the government subsidizes us. The exclusion favors most those of us who have the most generous health insurance policies. Moreover, because more insurance means that we face even less of the cost of what we buy – we and our doctors now bargain over what the plan, not us, will pay – we demand more care and more expensive care. . . . Additionally, the increased demand for health care tends to encourage growth in the health care sector in a less than optimal way. For instance, it tends to encourage suppliers of medical care to increase the quantity of what we get, with less incentive to increase quality. (Steuerle, "Congress Spends More to Increase Number of Uninsured," 12 April 2004)

It is important to note that this tax policy came about not by plan, but as an accident of historical events. During the Second World War, when the Federal Government imposed wage and price controls, employers sought to attract workers from a tight labor pool by offering modest health coverage, and excluding the costs from wages. When these employers sought endorsement of the practice from the Internal Revenue Service [IRS], the IRS approved. After the war, when the IRS tried to rescind this decision, Congress wrote it into law. The exclusion, which this year totals an estimated $151.8 billion, has made employer-provided coverage the most common form of health insurance.

Although the employer-based tax benefit has been important to the provision of health care, it has evolved into an expensive, inflexible, and unfair subsidy. It also contributes to the insecurities felt by those who have employer-based health insurance, because they fear sacrificing coverage if they lose or change jobs.

The tax provision also has failed to encourage the expansion of health coverage. Since 2000, the percentage of businesses offering health benefits has fallen 69 percent – mainly due to the continued rise in insurance costs. Rising costs also make health coverage unaffordable to many small businesses, self-employed persons, and low-income persons. Indeed, the current tax policy actually *increases* the number of the uninsured, according to Dr. Steuerle:

> As the increased amount of money spent on the exclusion effectively increases the average cost of health care and of health care insurance, the greater the number of individuals in the economy who forego purchasing private health insurance. Not only are low-income people more likely to avoid purchasing health insurance, but many middle-class people and people between jobs decide to take a chance and save the amount of the health insurance premium. Employers, beset by demands from their workers for cash wages, are also more likely to drop health insurance. At times, this happens directly, but more often than not it works its way into the system indirectly. The company with expensive health care insurance reduces the number of its employees, or, if growing, tries to outsource to groups for whom it does not have to pay for insurance. New companies without health insurance displace older ones that carry health insurance. (Steuerle, "Congress Spends More to Increase Number of Uninsured," 12 April 2004)

The third-party insurance arrangement also sharply reduces the options of health coverage packages available. Americans are limited in their choices of health insurance plans based on what their employers can afford – if a health plan is even offered at all. Consequently, Americans are deprived of a diverse health insurance market in which they can find affordable coverage options truly suited to their needs.

Adding to the problem is the lack of transparency in health care price and quality data, which further prevents patients from making the kinds of judgments they do in purchasing other services. For example, in the Milwaukee, WI area a heart bypass operation costs $100,000 at one hospital, while the same procedure costs $48,000 at another. Yet patients, and sometimes even doctors, are unaware of this difference.

Obviously, nearly all patients would rely on third-party coverage for such an event; it is the kind of episode for which consumers most need insurance. But because prices are opaque, patients have no incentive even to consider and compare them – let alone variations in the quality of services – in choosing where to undergo such procedures.

Medicaid

In fiscal year 2006, 63.2 million people were enrolled in Medicaid at some time during the year. Some 31.1 million of these beneficiaries were children, and 16.2 million were adults in families with dependent children. The program has provided Americans of limited means access to health care they could not have obtained otherwise.

But Medicaid spending, too, is spiraling out of control: it is growing at a rate of about 7.5 percent per year, and the combined Federal and State costs to run this program in fiscal year 2006 was $308.6 billion. State budgets are overwhelmed with these costs and Federal officials are struggling to meet the growing fiscal needs required to keep this program running. At the same time, Medicaid has fostered a two-tiered hierarchy within the health care marketplace that stigmatizes Medicaid enrollees. Providers are paid based on bureaucratically determined formulas that do not reflect the market. As a result, fewer and fewer providers are willing to participate in the program, meaning longer lines for beneficiaries, fewer operational clinics, and insufficient care.

Patients suffer as a result. With administrators looking to control costs and providers refusing to participate in a system that severely under-reimburses their services, Medicaid beneficiaries ultimately are left navigating an increasingly complex system for even the most basic of procedures.

Medicare

When President Johnson signed Medicare into law more than 40 years ago, he cited a principal goal of the program that cannot be achieved under its current spending path: "No longer will young families see their own incomes, and their own hopes, eaten away simply because they are carrying out deep moral obligations to their parents, and to their uncles, and their aunts." Absent reform, however, the program will end up delivering exactly what it was created to avoid: it will consume the prosperity of today's younger generation to finance an unsustainable path of spending.

Medicare was created with the worthy mission of providing health coverage for America's retirees, and for many it has done so. But the program suffers from unsustainably rapid spending increases that continue to drain economic and fiscal resources on its way to insolvency. In short, the program, as currently structured, cannot keep its promises to future generations.

The cost of Medicare has always been higher than expected. For example, in 1965 it was estimated that benefit payments for Medicare's Hospital Insurance [HI] program would total $8.8 billion in 1990. The actual spending was $65.7 billion (see Table 3). (Note: Robert J. Myers, the actuary who made the estimate, has disputed this comparison, arguing it would be more appropriate to compare benefits based on percentages of taxable payroll, and making other adjustments. But even on his terms, he concedes actual 1990 spending was 165 percent higher than estimated in 1965.)

Today, Medicare outlays are growing at a rate of 6.5 percent per year, more than twice the rate of current real GDP growth. Over the next 20 years, during which per-capita GDP is projected to grow an average of 1.1 percent per year, per-capita Medicare spending will increase by twice that amount, 2.2 percent, rising from $10,685 in 2006 to $18,116 in 2030 (adjusted for inflation). In coming decades, Medicare's per-capita spending rates will combine with a shift in the character of the U.S. population – toward one with a larger pool of retirees relative to workers – worsening its financial problems.

To rescue Medicare from financial collapse requires transforming the program to make it financially sustainable, and more consistent with the character of medical care in the 21st century.

Table 3: Estimated and Actual Benefit Payments for Medicare Hospital Insurance (Part A) Program
(dollars in millions)

Calendar Year	Estimated Part A Benefit Payments, 1965[a]	Actual Part A Benefit Payments[b]
1970	2,860	4,804
1975	4,047	10,353
1980	5,307	23,793
1985	6,860	47,710
1990	8,797	65,722

[a] From the Committee on Ways and Means, *Actuarial Cost Estimates and Summary of Provisions of the Old-Age, Survivors, and Disability Insurance System as Modified by the Social Security Amendments of 1965 and Actuarial Cost Estimates and Summary of Provisions of the Hospital Insurance and Supplementary Medical Insurance Systems as Established by Such Act*, 30 July 1965, Table 11.
[b] From the Office of Management and Budget, Historical Tables: *Budget of the U.S. Government – Fiscal Year 2009*, Table 13.1.
Note: Robert J. Myers, the actuary who prepared the 1965 estimates, has disputed comparisons such as those above, arguing that a more accurate comparison would be based on percentages of taxable payroll, along with other adjustments.

RETIREMENT

When Social Security was enacted in 1935, there were about 42 working-age Americans for each retiree. The average life expectancy for men in America was 60 years; for women it was 64. Hence it was easy for the program to generate sufficient revenue to meet its promises to those over 65. The initial Federal Insurance Contributions Act [FICA] tax rate was 1 percent each for workers and employers, up to $3,000 of income.

But even President Roosevelt knew this could not last. "Roosevelt himself saw that while the program's revenues might cover its costs now, the numbers from the actuaries suggested that there would not be enough money for old-age pensions for future generations." (Amity Shlaes, *The Forgotten Man: a New History of the Great Depression*, 2007)

President Roosevelt was right; and today, the challenge facing Social Security is more inexorable than at any time in the past – including the near-collapse of 1983. What's more, the risk to Social Security is nearer at hand than most acknowledge. The Social Security surplus will begin to shrink starting next year, 2009, and the program will hit a "negative cash flow" – when annual benefit payments exceed annual payroll tax revenue – less than a decade from now.

The cash flow trend is significant for the following reasons. Since the 1983 Social Security reform, the program's trust fund has run substantial cash surpluses: it has been collecting significantly more in dedicated tax revenue than it needed to pay annual benefits. These cash surpluses were "borrowed" by the general fund to finance other government programs, and were replaced by government bonds that promised the cash would be returned when needed, with interest.

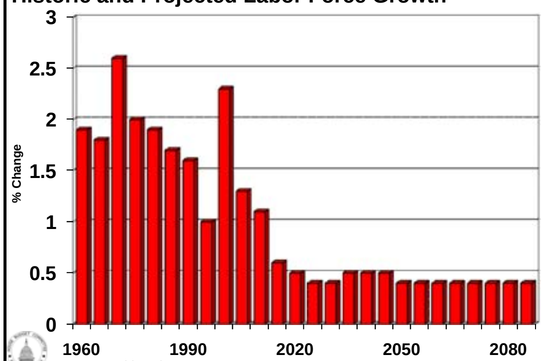
In 2017 Social Security will have to begin redeeming the trust fund bonds that have accumulated in recent decades. This will lead to one of four options, or some combination: 1) other government programs will have to be squeezed to finance Social Security; 2) taxes will have to be raised sharply to cover benefits; 3) benefits will have to be cut; or 4) the government will have to run large and chronic deficits to pay Social Security benefits. By 2041, the Social Security Trust Fund will be exhausted and the program will be unable to pay all of promised benefits to seniors. Without reform, benefits will have to be cut by 22 percent, or payroll taxes raised by 28 percent.

The latter would tear the social fabric of the program itself. "Hiking payroll taxes is neither an economically sound nor a generationally equitable option." says Robert L. Bixby, Executive Director of the Concord Coalition. "The burden will fall most heavily on lower- and middle-income workers and on future generations. Younger Americans in particular will be skeptical of any plan that purports to improve their retirement security by increasing their tax burden and by further lowering the return on their contributions." (Bixby testimony to the Senate Finance Subcommittee on Long-Term Growth and Debt Reduction, 28 September 2006)

As is well known, a major part of the problem is demographic. The first members of the baby-boom generation – those born between 1946 and 1964 – are now eligible for early retirement. At the same time, life expectancies now average 75 years for men and 80 years for women – and these too are expected to lengthen. These factors result in a permanent, long-term shift in which the percentage of the U.S. population over 65 will grow from 12 percent in 2007 to 19 percent by 2030, and the share of those who are 20 years old to 64 years old is projected to decline from 60 percent to 56 percent. The effect on Social Security translate as follows: today there are only 3.3 workers for each Social Security beneficiary, and that number is projected to fall to 2.2 by 2030, and continue dropping thereafter. These figures compare with the 42 workers per Social Security-eligible retiree in 1935, and 16 workers per beneficiary in 1950.

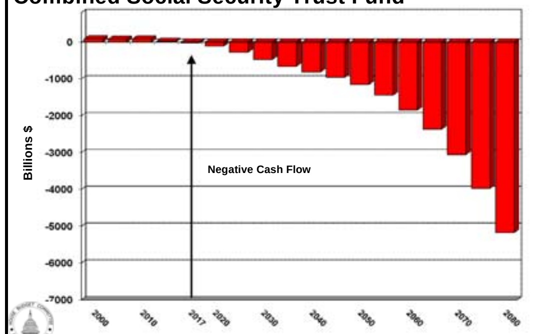
This demographic realignment is not a temporary phenomenon, associated solely with the retirement of the baby boomers, but a long-lasting shift; and it is more than a problem for Federal Government spending: it poses a challenge to the economy to generate sufficient resources to support the income and health needs of a growing population of retirees. Long-term economic growth depends on two factors: employment growth and productivity growth. But employment growth is tied to an expanding labor force, which under current projections is expected to decline (see Figure 1). As the nonworking-age population grows, there will be lower labor force participation and therefore lower per-capita output and consumption. The economy will need some means of boosting labor-force growth, or compensating for the lack of it, to support future retirees.

Figure 1
Historic and Projected Labor Force Growth



Source: 2008 Social Security Trustees Report

Figure 2
Projected Cash Surpluses and Deficits in the Combined Social Security Trust Fund



Source: 2008 Social Security Trustees Report

But even if the prospects for economic growth could be vastly improved – by enhancing productivity and wages, for example – it would not ease the problem with Social Security, because the program's benefits are partly indexed to such economic factors. "[B]ecause of the structure of Social Security, that growth in productivity and wages automatically translates into higher future benefits, offsetting a significant portion of the fiscal gains from a larger economy," says a recent paper by the Brookings-Heritage Fiscal Seminar. "In short, if the status quo continues and entitlement programs are not reformed, there is no feasible growth rate of the economy that will produce a sustainable budget path." (The Brookings-Heritage Fiscal Seminar, *Taking Back Our Fiscal Future*, April 2008) (The Seminar is a bipartisan group that includes representatives from The Brookings Institution, The Heritage Foundation, The Urban Institute, The American Enterprise Institute, The Concord Coalition, The New America Foundation, and The Progressive Policy Institute.)

The combination of demographic and benefit patterns will drive total Social Security spending to unprecedented levels. CBO estimates that by 2030 the average Social Security benefit will have grown by about 29 percent in real terms, and adds: "[U]nless changes are made to Social Security, spending for the program will rise from 4.3 percent of GDP in fiscal year 2007 to 6.1 percent of GDP by 2030. With further increases in life spans, spending for Social Security will gradually rise thereafter, reaching 6.4 percent of GDP in 2082." (CBO, *The Long-Term Budget Outlook*, December 2007)

There are other reasons to reform Social Security.

First, the current program is not a good deal for workers. For the average individual currently paying in to the system, the real rate of return from Social Security is between 1 percent and 2 percent. For some individuals, particularly younger ones, the rate of return is expected to fall below 1 percent. To place this in context, the average rate of return from the stock market since 1926 has been at least 7 percent.

Second, the current system is unfair to minorities. The projected shorter life expectancies of minorities significantly reduces their benefits compared with Caucasians. For example, a 30-year old white man with average earnings and average life expectancy will receive nearly $70,000 more in lifetime Social Security benefits than an African American man with the same characteristics.

Third, women who work outside the home also are treated unfairly. The reason is that a woman is entitled to the benefit based on her lifetime earnings or 50 percent of her husband's benefits, but not both. Consequently, a woman who has worked for many years and paid into the system but elects to accept benefits based on her husband's income will receive nothing more than a woman who worked for a short period of time or not at all. This method of calculating benefits is outdated and based on the single-worker home that was much more prevalent in the U.S. in the 1930s.

Fourth, today's workers have no rights in their Social Security benefits. According to the Supreme Court in *Flemming v. Nestor*, workers and their families have no legal claim on the payments that they make into the U.S. Treasury. As a result, Congress is free to change these benefits at any time.

Finally, Social Security benefits are not inheritable. A worker may pay into the Social Security system for a lifetime and have nothing to pass on to heirs – in stark contrast with other types of retirement funds that *are* inheritable.

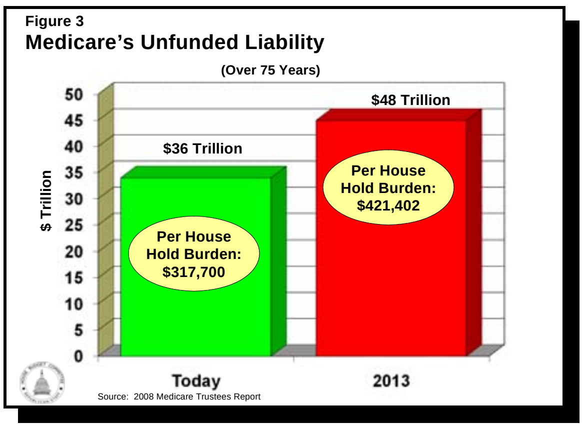
UNFUNDED LIABILITIES

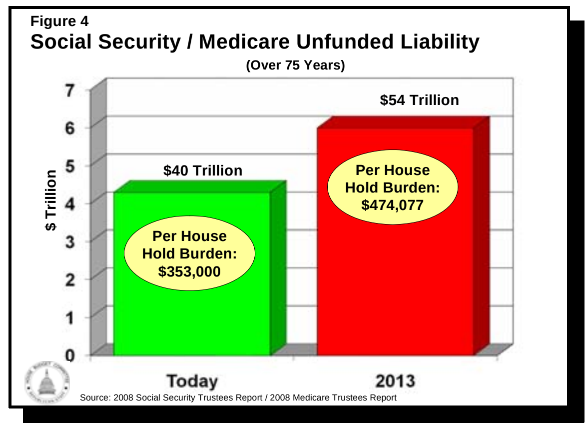
The fiscal challenges resulting from these health and retirement trends are best illustrated by what are frequently called the "unfunded liabilities" of the Federal Government's major benefit programs. These liabilities reflect the excess of projected spending in these programs over the amount of revenue currently estimated to be available for them.

The problem is most acute in Medicare. The program faces similar demographic patterns as those confronting Social Security. But its much larger challenge is that of medical costs, which are rising at roughly double the rate of growth in the economy. Today Medicare has an unfunded liability of $36 trillion over the next 75 years (see Figure 3 on the next page). This means that the Federal Government would have to set aside $36 trillion today to cover future benefits for the three generations of Americans: retirees, workers, and their children. This translates to a burden of about $317,000 per U.S. household. Moreover, the problem worsens rapidly: in just the next 5 years, by 2013, Medicare's unfunded liability is projected to grow by 33 percent, to $48 trillion – or about $412,402 per household.

When Social Security and Medicare are taken together, the total unfunded liability is $40 trillion, or about $353,000 per household (see Figure 4, next page). In the next 5 years, that total will grow to $54 trillion, or $474,077 per household.

Without fundamental changes, the government would have to finance these obligations with substantially higher taxes, higher debt, or a combination of the two. Either way, the results would be crippling for the U.S. economy, because they would entail transferring an unprecedented level of economic resources away from growth-generating activities of the private sector. "[A]bsent a significant rise in revenue beyond the historical level of GDP, spending on Social Security, Medicare, and interest on the debt could squeeze out all other areas of the budget," write Maya C. MacGuineas, Director of the Fiscal Policy Program at the New America Foundation, and Stuart M. Butler, Vice President for Domestic and Economic Studies at the Heritage Foundation. "Taxes could, in principle, be increased to cover these costs, but the unprecedented tax levels required would have an extremely negative impact on employment, wage growth, and our ability to compete internationally. Borrowing to pay for the programs, on the other hand, would lead to such high deficits that the debt would be unsustainable." (MacGuineas and Butler, *Rethinking Social Insurance*, 19 February 2008)





But this is not all. Former Comptroller General David M. Walker has noted that apart from the three major entitlement programs, the Federal Government incurs a range of other obligations that already are binding future resources.

> The Federal Government undertakes a wide range of programs, responsibilities, and activities that obligate it to future spending or create an expectation for spending and potentially limit long-term budget flexibility, GAO has described the range and measurement of such fiscal exposures – from explicit liabilities such as environmental cleanup requirements to the implicit obligations presented by life-cycle costs of capital acquisition or disaster assistance. . . . [I]f we wanted to put enough aside today to cover these promises, it would take $170,000 for each and every American or approximately $440,000 per American household. Considering that median household income is about $46,000, the household burden is about 9.5 times median income. (Walker testimony to the Committee on the Budget, U.S. House of Representatives, 23 January 2007)

Even without these additional obligations, reforming Federal entitlements would be imperative; with them, the need is absolute.

THE INTERNATIONAL MARKETPLACE

In the 21st century, the oceans no longer separate national economies. With the deployment of broadband technology and a host of other, new technological advancements, the U.S. economy is interrelated and international. The force of competition is fierce, with the rapidly growing economies of China and India playing especially vigorous roles. Virtually no worker or industry is immune from these new competitive realities. In confronting this new economic reality, America needs a plan that not only helps workers cope with this new economic anxiety, but also wins this new international competition. In this respect, lessons from past failures and successes are instructive.

In the 19th and 20th centuries, America came into a league of its own in terms of rapid economic achievement, rising living standards, and international competitiveness. Several factors contributed – principally a reliance on the individual and private markets – which generated innovation and growth that laid the groundwork for increased prosperity.

Since 1995, The Heritage Foundation and *The Wall Street Journal* have published the *Index of Economic Freedom*, which tracks the economic progress of 162 nations. The results are clear: countries with relatively modestly sized governments that embrace economic and individual freedom are the wealthiest in the world. Consistently, America ranked among the top; and today, other nations are providing stiff competition to the U.S. by reforming their economic policies to emulate this economic strategy (see Table 4).

Table 4: Index of Economic Freedom, 2008: Top 10 Countries

Country	Overall	Size of Government	Fiscal Freedom	Property Rights	Business Freedom	Labor Freedom
Hong Kong	90.25	93.07	92.8	90	88.18	93.3
Singapore	87.38	93.87	90.3	90	97.79	99
Ireland	82.35	64.5	71.5	90	92.22	80.4
Australia	82	62.83	59.2	90	89.32	94.2
United States	80.56	59.81	68.3	90	91.69	92.3
New Zealand	80.25	55.99	60.5	90	99.9	85.5
Canada	80.18	53.67	75.5	90	96.74	82.9
Chile	79.79	88.24	78.1	90	67.48	90
Switzerland	79.72	61.55	68.0	90	83.89	82
United Kingdom	79.55	40.06	61.2	90	90.79	80.7

Source: Copyrighted data from The Heritage Foundation and *The Wall Street Journal*.
Note: Scores are based on a scale of 0 to 100, with 100 reflecting "an economic environment or set of policies that is most conducive to economic freedom." These are selected items from the index, which ranks 162 nations on the basis of 10 benchmarks of "liberty, prosperity, and economic freedom." The other benchmarks in the complete index are trade freedom, monetary freedom, financial freedom, investment freedom, and freedom from corruption.

The Federal Reserve Bank of Dallas, which has been researching the link between global competition and pubic policy, concludes that in such a world, "countries win by instituting better policies and lose by *overburdening* their economies with taxes, regulations, trade barriers, and policy instability." (Federal Reserve Bank of Dallas, *Racing to the Top*: *How Global Competition Disciplines Public Policy*) The Dallas Fed's research shows that the most successful countries in this era are the ones that promote faster growth, lower inflation, higher incomes, and greater economic freedom.

Unfortunately, America's status as the world's leading economic power is clearly threatened by the trajectory of current Federal Government fiscal policies. As a result, to support continued prosperity and rising standards of living, it is crucial for the U.S. to embrace policies that will promote its leadership in the international marketplace, and to acknowledge the increasing importance of individual freedom and private markets.

Government Spending

Most analyses of the Federal Government's fiscal outlook focus on growing budget deficits and growing debt. These are legitimate concerns; but they should not obscure the fundamental problem: *government spending*.

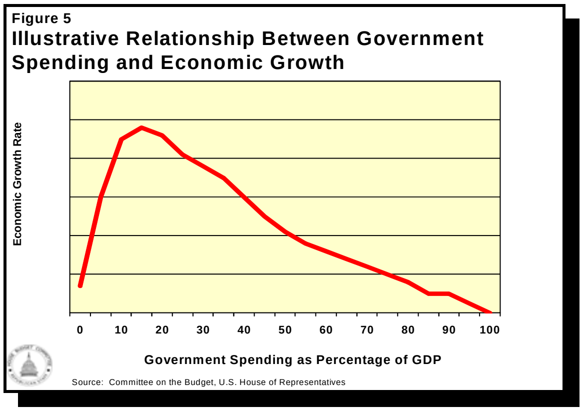
In contrast to a business – which seeks to raise income as an end in itself – government raises revenue solely because it must, to support its spending. With government, therefore, spending is the root cause of all fiscal consequences. Put another way, all government spending gets financed, through either taxes or borrowing; and both consume resources that otherwise could be used for consumption or investment in the economy. The more government spending grows, the less resources are available for expanding the economy. This is why economic research generally confirms the theory that high levels of government spending tend to be associated with slower economic growth.

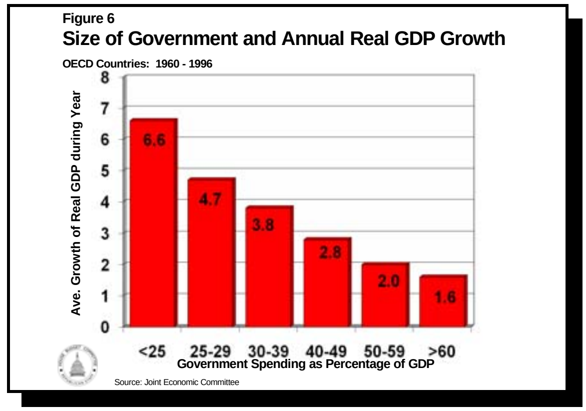
According to CBO, government spending as a share of the economy (a proxy for the size of government) is projected to double to more than 40 percent of gross domestic product by 2050 (see further discussion in the next section). Raising taxes or borrowing to meet these spending needs will cripple the economy and destroy U.S. international competitiveness.

High government spending tends to crowd out more productive private sector investment, which leads to declines in productivity and lower GDP growth. Redistributive spending – the kind involved in Federal entitlement programs – also distorts the allocation of resources in the economy; and an increasing domination in the form of government intervention and spending can erode private markets. Redistributive government spending also sets up incentives to capture the benefits of government transfers and subsidies rather than engaging in productive behavior. As government grows and assumes increasing responsibility for services that could be more efficiently provided by private markets, diminishing rates of return on government spending set in. In addition, the high tax rates needed to fund government spending also depress the incentives to work, save, and invest. High tax rates dampen entrepreneurial activity and risk taking, factors that are particularly important in a modern, dynamic economy.

In short, *higher tax rates discourage the forms of productive behavior that are crucial for long-term economic growth*.

Figure 5 on the next page shows the general relationship between government spending and economic growth. Obviously, some government spending is necessary to foster a functioning market economy. Governments must provide for a limited set of public goods: they must build roads and other infrastructure, foster the protection of property rights, and maintain internal and external security. As the upward-sloping portion of the curve illustrates, this “core” government spending tends to foster economic growth. But when government spending increasingly exceeds these core functions, economic growth begins to suffer. (i.e. countries reach the downward sloping portion of the curve). As the figure illustrates, past a certain level, more government spending and higher levels of taxation begins to lead to slower rates of economic growth.





This general observation is borne out in the real world. The Joint Economic Committee has studied the relationship between the size of government and economic growth in 23 industrialized countries during 1960 through 1996 (see Figure 6). The results show, for instance, that countries with government spending in excess of 40 percent of GDP experienced less than half the rate of GDP growth, on average, than countries with leaner governments (i.e. between 25 percent and 39 percent of GDP). The committee’s econometric analysis of the international data yields a convenient rule of thumb: an increase in government spending of 10 percentage points tends to reduce a country’s annual rate of GDP growth by about 1 percentage point.

These kinds of studies show that America’s budgetary problems cannot be solved by simply increasing government and raising taxes. The economic cost of this route would be devastating.

Taxes

While government spending drives the need to tax (or borrow), the Federal tax code as currently written will become a kind of “revenue machine,” claiming ever-growing shares of individuals’ income and the economy’s resources. Under current-law projections by CBO, tax revenue is scheduled to approach an unprecedented one-fourth of GDP by mid-century. To put this in context, Federal revenue has exceeded 20 percent of GDP only once since the Second World War, and it has averaged about 18.3 percent in the past 40 years.

The start of this reckoning is near at hand. As Professor Michael J. Graetz of Yale Law School recently put it:

> [T]he scheduled expiration in 2010 of large tax cuts enacted in 2001 and 2003 builds a large tax increase into the current tax law. If Congress fails

> to act, income tax rates will rise, as will tax rates on capital gains and dividends, and people will lose many current benefits, including credits for children and relief from marriage penalties. Under current law, the estate tax exemption rises to $3.5 million next year with a 45-percent top rate, the tax is repealed in 2010, and in 2011 the tax comes back with a $1 million exemption and a 55 percent top rate. . . . And, as this committee knows well, the Alternative Minimum Tax [AMT] is currently structured in a way to catch millions more Americans and must be fixed or repealed. (Graetz testimony to the Committee on the Budget, U.S. Senate, 15 April 2008)

The AMT is in fact a perfect example of the faulty assumptions in Federal tax law. When originally enacted, the tax was designed to prevent a small number of high-income individuals to avoid paying taxes by manipulating the complex rules of an already flawed tax code. But because Congress failed to index the AMT for inflation, the tax threatens, every year, to ensnare millions of middle-income families. CBO estimates that, if left unchanged, the AMT would hit about two-thirds of American taxpayers by 2050. Nearly everyone agrees this scheduled AMT expansion is illegitimate; and though each year Congress has tried to “patch” the AMT, its expected revenue increase is built into current law projections, creating a presumption of higher revenue that masks the magnitude of budget deficits that the current path of government spending will create.

In addition, individual income taxes are needlessly complex, riddled with special provisions that manipulate individuals taxpayers’ behavior and reduce economic efficiency. Professor Daniel N. Shaviro of the New York University School of Law has testified: “[T]he tax system needlessly aggravates and complicates the lives of lower and middle income taxpayers. Congress can and should address this, by making filing and compliance less painful, even insofar as taxes paid by such individuals remain approximately constant.” (Shaviro testimony to the Committee on the Budget, U.S. Senate, 15 April 2008)

Taxes impose two types of economic costs: the direct cost of the taxes themselves, and the indirect costs of the changes in behavior that result. For instance, taxes can affect the incentive to work. When marginal income tax rates are high, they penalize productivity, as people keep less of their earnings. This reduces the potential to maximize labor force participation.

The U.S. tax system also discourages capital investment, a necessary component of long-term growth and rising living standards, by essentially taxing savings twice. Individuals pay income taxes on their wages and salaries and, if they choose to save these funds, pay another round of taxes when they reap investment gains. This arrangement encourages individuals to consume their wages and salaries immediately rather than saving and investing them.

The double-taxation of corporate profits offers another example of the disincentive effects on investment of the current U.S. tax code. Corporate profits are taxed once at the business level and once again at the individual level, when the profits are distributed as dividends or capital gains. This double taxation boosts the cost of capital and leads to lower investment in the corporate sector.

In short, tax policy is a key element that will influence the two components of long-term economic growth: investment and labor force participation.

Here are several other factors that come into play in tax policy.

Tax Rates. The importance of taxes to competitiveness is echoed by a recent study released by the U.S. Treasury. Treasury finds that business location and investment decisions are becoming more sensitive to country tax rates as global integration increases. Foreign investment is important to an economy because it is a key source of innovation and jobs. In response, many countries have been lowering business taxes. But the U.S. risks falling behind: it already has the second highest corporate income tax in the Organisation of Economic Cooperation and Development [OECD] (see Figure 7 on the next page). The U.S. may soon have the highest rate, as Japan, Germany, France, and the United Kingdom have signaled their intention to lower their corporate income tax rates. As described by Robert J. Carroll, Vice President for Economic Policy at the Tax Foundation:

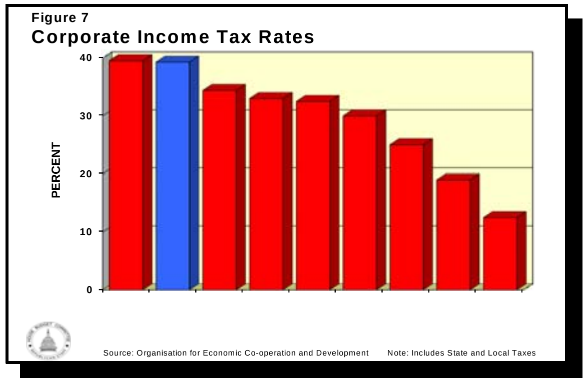
> By standing still, the United States can expect to see reduced inflows of foreign capital and investment because the United States will be a less attractive place in which to invest, innovate and grow. U.S. firms will face a higher cost of capital than foreign firms, making it more difficult to compete in foreign markets. In the near-term, this would translate into slower economic growth, a slower advance in labor productivity, and less employment. The industries that are being hurt the most are those that manufacture or buy capital-intensive products. (Carroll testimony to the Committee on the Budget, U.S. Senate, 15 April 2008)

Although corporate taxes may be a politically popular revenue source, they actually create perverse incentives that impede economic growth, and therefore penalize workers and consumers.

> Economists are unanimous . . . that the corporate tax is a bad one. It creates incentives for investing in noncorporate businesses and housing instead of corporations, and it induces many distortions in corporate finance. For example, since interest but not dividends are deductible and thereby not subject to the corporate tax, the tax creates a bias in favor of debt over equity finance. The combination of individual and corporate income taxes also has created an advantage for corporations to repurchase shares rather than paying dividends. The invention and deployment of innovative financial products has added new distortions as companies structure their financial transactions to achieve income tax advantages. The internationalization of businesses, along with the greater mobility of capital, has made collecting corporate income taxes much more difficult. Companies, for example, now routinely manipulate their corporate structures, finances and inter-company prices to take advantage of lower corporate tax rates in other countries. These are just some of the reasons that economists hate a tax the public seems to love. (Graetz testimony to the Committee on the Budget, U.S. Senate, 15 April 2008)

Elevated corporate tax rates hinder American competitiveness by making the U.S. a less desirable destination for investment and jobs. By deterring potential investment, the tax restrains economic growth and job creation. The U.S. tax rate differential with other countries also fosters a variety of complicated multinational corporate behaviors intended to avoid the tax – profit shifting, corporate inversions, and transfer pricing – which have the effect of moving the tax base offshore, costing jobs and decreasing corporate revenue.

U.S. tax policies also create an unlevel playing field in the international market. One example is the General Motors Tahoe, manufactured in Janesville, WI. When the vehicle is exported to a foreign country, such as Japan, taxes are paid in the U.S. before it is shipped, and again when it reaches its destination. By contrast, when a Toyota Sequoia is shipped from Japan, the Japanese government lifts taxes before it is exported, and the vehicle arrives tax-free when it reaches the U.S. Clearly, this combination of tax policies places the American-built vehicle at a competitive disadvantage when compared with its Japanese counterpart.



Tax Certainty and Consistency. Equally important over time is maintaining a consistent and predictable tax policy. Only in such an environment can businesses effectively plan the long-term investments needed to sustain economic growth. In addition, foreigners will be unlikely to invest in the U.S. if they conclude that U.S. tax laws are likely to keep changing, or rates to keep rising.

Flexibility and Adaptability. In an ever-changing international marketplace, economic flexibility and adaptability are increasingly important. The U.S. economy has been successful historically due in part to its flexible and efficient capital markets, which direct investment resources to their most productive uses – seeking out new and profitable ventures and redeploying investment from old industries into the fields. High tax rates on investment and capital can impair this innovation dynamic and can harm U.S. economic competitiveness.

Debt

Even the unprecedented levels of taxation described in the previous section will be inadequate to match the path of government spending embraced in current law. The result will be increasing government borrowing and debt. The accumulating debt will crowd out more productive private-sector investment, and thereby lower capital formation. That in turn will lead to productivity declines and lower rates of real economic growth, materially affecting living standards. The U.S. will have to rely on foreign investors to finance this debt, but these investors would soon realize that the path of the deficit was unsustainable. As a result, foreign investors will likely reduce their purchases of U.S. securities, which could cause a reduction in the exchange rate of the dollar; interest rates could rise, and consumer prices would face upward pressure. With higher interest rates, sharp inflationary pressures, and a mix of fundamentals that will lower business profits, the stock market would also dip.

In short, the debt arising from current government spending trends is sacrificing the prosperity of future generations. This trend is in place now, under current laws, and is inevitable without a fundamental transformation of America's domestic priorities.

THE NEED TO ACT NOW

Even Friedrich A. Hayek, who warned about the limitations of central planning in addressing social needs, acknowledged that government could play a legitimate and effective role in assuring the domestic welfare of a society, including the maintenance of a safety net for those less well off:

> All modern governments have made provision for the indigent, unfortunate, and disabled and have concerned themselves with questions of health and the dissemination of knowledge. There is no reason why the volume of these pure service activities should not increase with the general growth of wealth. There are common needs that can be satisfied only by collective action and which can thus be provided for without restricting individual liberty. . . . There is little reason why the government should not also play some role, or even take the initiative, in such areas as social insurance or education, or temporarily subsidize certain experimental developments. (Hayek, *The Constitution of Liberty*, 1960)

What he objected to were attempts by central planners in governments – especially central governments – to monopolize these efforts. Such approaches tend to be cumbersome and excessively costly. They also limit personal liberty.

To the extent the Federal Government has moved in that direction since the 1930s – from the New Deal, through the Great Society, to today's debate about government's role in health care – the point is especially significant now: the social insurance strategies of the 20th century, however well intentioned, are unsustainable fiscally and economically. Their missions can be fulfilled – but only by transforming them.

The challenge is long term, but the need to address it is urgent. The longer policymakers delay, the worse circumstances will become, in many ways. As CBO has put it:

> Delays in taking action would create three major problems: First, delay would cause the amount of government debt to rise, which would displace private capital (reducing the total resources available in the economy) and increase borrowing from abroad. Second, delay would exacerbate uncertainty. The longer that action was put off, the greater the chance that policy changes would occur suddenly, which could create difficulties for some individuals and households, especially those in or near retirement. Announcing changes in popular entitlement programs or

> in the tax structure well before they take place gives people time to adjust their plans for saving and retirement. Those adjustments can significantly reduce the impact of changes in policy on people's standard of living. Third, delay would raise the cost of interest on the Federal debt, so that lawmakers would have to make ever-larger changes in policy to finance those additional costs. As interest costs rose, policymakers would be less able to finance other national spending priorities and would have less flexibility to deal with unexpected developments (such as a war or recession). Moreover, rising interest costs would make the economy more vulnerable to a crisis. (Testimony of CBO Director Peter R. Orszag to the Committee on the Budget, U.S. House of Representatives, 13 December 2007)

On the other hand, early action can be beneficial. It provides time to phase in changes, allowing beneficiaries time to adjust.

Nor will small or incremental actions suffice. "The American people know – or sense – that there is something wrong," says former Comptroller General David M. Walker. "[W]e cannot grow our way out of this problem; eliminating earmarks will not solve the problem; wiping out fraud, waste, and abuse will not solve the problem; ending the war or cutting way back on defense will not solve the problem; restraining discretionary spending will not solve the problem; and letting the recent tax cuts expire will not solve this problem." (Walker testimony to the Committee on the Budget, U.S. House of Representatives, 23 January 2007)

Transformation need not be some radical departure from American tradition. Instead it should rely on the fundamental strengths that have always brought out the best in American society: a reliance on individual creativity in free markets and a free society, with the support – not the interference – of government. It is the kind of fundamental restoration called for in this proposal and described in this report.